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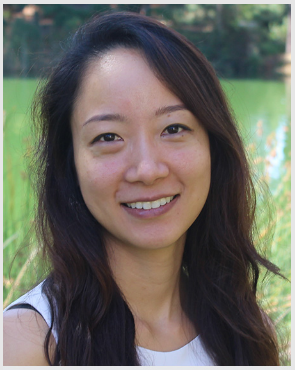
Healius: A Lost Opportunity for Australian Capital Allowance Reform

by Christina Allen



Christina Allen

Christina Allen is a lecturer at Edith Cowan University in Perth, Australia.

In this article, the author examines a recently dismissed High Court of Australia case that addressed whether a healthcare company's exclusive sales agreements constitute capital expenditure, arguing that the case was a missed opportunity to test the judicial characterization of intangible wasting assets and that it highlighted Australia's deficient capital allowance rules.

Australia's judicial characterization of expenditure has been highly ambiguous. For instance, legal expenses incurred to oppose the grant of a potential competitor's statutory license are considered a capital expenditure;[1] yet the costs of entering exclusive sales agreements are immediately deductible.[2] Recently, Healius Ltd., one of Australia's leading healthcare companies, was in the latter position over payments made to medical practitioners providing services exclusively to Healius medical centers. The federal court initially held that the payments were capital expenditures; however, the full federal court overturned the ruling.[3] Healius later applied for special leave to the High Court of Australia, the country's final court of appeal. The Court dismissed the application in March, bringing the matter to a close.[4] Many tax professionals viewed this decision as a missed opportunity to test the status of judicial characterization of intangible wasting assets and, importantly, to highlight the ongoing tension caused by deficient capital allowance rules.

Potential Shift in Judicial Characterization

The business structure test is frequently invoked as the cause of ambiguous judicial characterizations. Australia has three primary judicial tests. The first two tests, which originated from the United Kingdom, are familiar to all legal practitioners: expenditure based on the recurrence of expenditure, and an enduring advantage created by expenditure.

The third presiding test, devised in the Australian court, is the business structure test. This approach makes a distinction between:

- expenditure attributable to the structure of a business; and
- expenditure incurred in running day-to-day activities of a business.

The first determines capital expenditure, whereas the second decides current expenditure. However, the major defect of this test is the subjectivity inherent in the process of inference. If the structure of a business is defined as broadly as business goodwill, for example, almost all expenditure can be considered capital expenditure. Thus, the money paid to cleaners can be categorized as capital expenditure because keeping the business premises clean and pleasant

[1] *Broken Hill Theatres Pty Ltd. v. Federal Commissioner of Taxation (Cth)*, (1952) 85 CLR 423.

[2] *BP Australia Ltd. v. Federal Commissioner of Taxation (Cth)*, (1965) 112 CLR 386.

[3] *Healius Ltd. v. Federal Commissioner of Taxation*, [2019] FCA 2011; *Federal Commissioner of Taxation v. Healius Ltd.*, [2020] FCAFC 173.

[4] *Healius Ltd. v. Federal Commissioner of Taxation*, [2021] HCASL 41.

attracts customers, thus enhancing business goodwill. Judge Brennan has noted that "[Goodwill] is frequently earned and maintained by the daily activities of those engaged in the business."[5] However, he conceded that the nexus to goodwill does not preclude expenditure from being current expenditure.

Notably, the business structure test was not the driver of the decision in *BP Australia*,[6] the case upon which Healius relied. This decision was decided by the Privy Council residing in the United Kingdom, which was the last court of appeal in Australia at that time. In dealing with exclusive sales ties, the Privy Council decided to allow immediate deductions in favor of the taxpayer. The decision was not grounded in any regulation or law. Rather, the Privy Council acknowledged that the taxpayer would find no deduction rule other than the immediate one before them in Australian tax regulations. Yet, on the very day the decision was handed down, the same members of the Privy Council, sitting as the House of Lords, conversely characterized the expenditure made for agreements in a United Kingdom case to constitute capital expenditure.[7] The latter case had no binding effect on Australian courts, whereas the decision influenced by the deficient statutory rules in Australia became a legal precedent.

Since *BP Australia* was decided in the 1960s, numerous intangible asset cases have been tried before Australian courts. Although many assets were characterized as capital in nature, the costs for the acquisition of exclusive lending rights, rights to operate public infrastructure and collect tolls and authorized dealership agreements, to name a few, were immediately deductible.[8] The courts have conferred different weight to the three characterization tests, reaching diverse rulings. However, the *ratio decidendi* has rarely been based on deficient statutory rules, and to be sure, common sense dictates that litigants cannot rely on such rules to persuade a court.

Australia has long awaited another such case to be tried before the High Court. The opportunity finally arose in 2019 in *Sharpcan*.[9] In this case, the High Court stamped capital expenditure on the costs paid to acquire multiyear gaming licenses. The licenses were regarded as assets of enduring value and used as the means of continuing the business, hence categorized as part of the structure of the business. The Court remarked that the decision in *BP Australia* was perhaps best understood as payments incurred in recurrent dealing to encourage customers (that is, retail gas stations) to buy the company's products — that is, as a business process.

The decision in *Sharpcan* was not entirely satisfactory. If the costs for acquiring limited-life intangible assets fell under capital expenditure, this meant that these expenses would be recognized upon disposal or when the assets expired. This would fall under the capital gains measures that were primarily designed for non-wasting assets on the grounds that it is problematic to make objective measurements of changes in the value of non-wasting assets during the holding period. The absence of a capital allowance to deduct the costs of the gaming licenses leads to one of the two outcomes:

- the taxpayer gets a windfall if immediate deductions are allowed; or
- the taxpayer must pay a penalty if immediate deductions are denied.

The decision in *Sharpcan* was soon followed by *Healius*. The *Healius* case continued through 2020 on its path to elucidate judicial views in connection with the long-held precedent in *BP Australia*. As with *Sharpcan*, the taxpayer faced one of two options, a windfall or a penalty, in the absence of a relevant capital allowance.

Defective Capital Allowances

Australian income tax legislation has a generic, so-called uniform regime to provide capital allowances for assets that have a limited life and are reasonably expected to decline in

[5] *Magna Alloys & Research Pty Ltd. v. Federal Commissioner of Taxation*, (1980) 45 FLR 183, at 201.

[6] *BP Australia Ltd.*, (1965) 112 CLR 386.

[7] *Regent Oil Co. Ltd. v. Strick*, [1966] AC 295.

[8] *National Australia Bank Ltd. v. Commissioner of Taxation (Cth)*, (1997) 80 FCR 352; *Federal Commissioner of Taxation (Cth) v. CityLink Melbourne Ltd.*, (2006) 228 CLR 1; and *Tyco Australia Pty Ltd. v. Commissioner of Taxation*, (2007) 67 ATR 63.

[9] *Federal Commissioner of Taxation v. Sharpcan Pty Ltd.*, [2019] HCA 36.

value over time. However, "assets" here generally means tangible assets. Intangible assets are counted only if explicitly specified and include:

- mining, quarrying, or prospecting rights;
- mining, quarrying, or prospecting information;
- patents, copyrights, and registered designs;
- in-house software;
- indefeasible rights to use (IRUs);
- spectrum licenses;
- data broadcasting transmitter licenses; and
- telecommunication site access rights.[10]

These eight categories of depreciable intangible assets are narrow in scope. They have been introduced to provide special preferences to specific industries, not because of any legal principle based on their intangible nature. For example, rights and information related to mining, quarrying, and prospecting have been deductible for many years as part of a special industry regime that recognizes various costs involved in resource extraction and processing. Patents, copyrights, and registered designs became depreciable when the government noticed that businesses were paying excessive license fees rather than acquiring intellectual property (the costs of acquiring IP were not deductible at that time).

Regarding in-house software, in 1998 the Commissioner of Taxation withdrew its 1979 ruling that had permitted taxpayers to immediately deduct the costs of software acquisition. The withdrawal happened because the commissioner came to realize that its relatively straightforward administrative practice was not in line with the judiciary's far more complex characterization of current expenditure. The depreciation of spectrum and data broadcasting transmitter licenses was introduced when they became subject to market auctioning systems in the 1990s. This change was intended to help domestic bidders compete against their international counterparts that could access tax depreciation rules in their domestic jurisdiction. IRUs for international cables were included in the 1999 decision to provide tax relief for costs that were otherwise recognized under the capital gains system. Six years later, IRUs for domestic cables were added as the telecommunications industry lobbied for consistent treatment across all IRUs. Simultaneously, telecommunication site access rights, often granted hand in hand with IRUs for domestic cables, were added.

However, outside the uniform capital allowance regime, the depreciation of intangible assets is limited. By default, intangible assets are subject to capital gains measures.[11] This tax treatment under the capital gains measures is discriminatory. For one thing, costs are only recognized upon expiry, cancellation, abandonment, forfeiture, or any similar ending that affects intangible wasting assets.

Take a 99-year casino license. If the license runs without disposal, the acquisition cost, which is unlikely to be small for a long-life asset, is only recognizable 99 years after the acquisition. Even then, the cost recognition is not guaranteed to reduce taxable income. According to the loss-quarantining rule, overall net capital gains are included in income, whereas net losses are carried forward to a subsequent year to be offset against future capital gains. Therefore, if a taxpayer ceases business operation before yielding sufficient offsettable capital gains, the amount that was never accounted in offsetting capital gains is lost.

In addition, the capital gains measures include no mechanism to uplift the costs of assets that yield a capital loss. Intangible assets that decline in value over time are at best recognizable on a historic cost basis. Although Australia's history of capital gains tax is relatively short (first legislated in 1986), it is only a matter of time before the problem with an investment bias against long-held assets will occur. Since fairness enjoins like things to be treated in a like manner, any income tax system that provides depreciation of wasting tangible assets must also do so for wasting intangible assets.

In 1999 the Review of Business Taxation (commonly referred to as the "Ralph Review" after the chairperson, John Ralph) submitted details on designing a generic capital allowance

[10] Income Tax Assessment Act 1997, section 40-30(2).

[11] Capital gains measures are contained in part 3-3 of the Income Tax Assessment Act 1997.

for rights and leases.[12] In response, the government considered the implementation of a generic capital allowance for wasting intangible assets but, after five years, decided against the measure. In its 2005-2006 budget, the government announced that the regime would make the tax laws more complex, raising integrity concerns. No change has occurred since then. The capital gains measures continue providing a fractured solution to recognizing the costs of a vast range of intangible wasting assets.

Implications of *Healius*

The dismissal of the special leave application lodged by Healius represented a lost opportunity to revisit the judicial standing of *BP Australia* in the 21st century. The payments made by Healius to secure the exclusive services of medical practitioners was remarkably like the payments that BP Australia had made to retail gas stations for trying their products. Those arrangements were also similar to the gaming licenses issue addressed in *Sharpcan*. However, the decision differed because of the way in which the Court distinguished the gaming licenses from the exclusive sales ties.

In *Sharpcan*, the company was required to obtain gaming licenses to continue its business operation. Applying the business structure test, it was difficult to argue that the licenses were not, in fact, part of the core business structure. Conversely, in both *Healius* and *BP Australia*, the firms offered lump sum payments to induce and provide an incentive for their clients, which the Court in *Sharpcan* considered closer to business processes. Thus, hearing *Healius* before the High Court was a necessary step to resolving the ambiguity of judicial characterization. Without this resolution, some will rely on *Sharpcan* and *Healius* to advise that courts are likely to characterize costs of intangible wasting assets as capital expenditure. Others will attempt to distinguish the decision in *Sharpcan* to apply *BP Australia*, making a novel distinction based on the ambiguous business structure test.

Had the High Court decided on immediate deductions in *Healius*, the extant standing of *BP Australia* would have been affirmed. This would have pressured the government to introduce a generic capital allowance. The new capital allowance would then become a more appropriate deduction rule, finally settled by the judicial characterization of current or capital expenditure. Conversely, upholding the full federal court decision would have provided certainty to many businesses and advisers on how to treat wasting intangible assets, even though a generic capital allowance might not be implemented in the immediate future.

It is expected that litigation will continue in the absence of appropriate capital allowances of wasting intangible assets. This calls into question the government's past decision to refuse a generic capital allowance because of the potential complexity of the tax law.

The tax system is complex and distortionary. The handful of intangible assets listed in the uniform capital allowance regime indicates that Australia can legislate and operate difficult depreciation rules. For instance, in the case of mining information and in-house software, wasting periods are often uncertain. Given the large volume of transactions occurring every day in the market that involve wasting intangible assets, it is a virtual certainty that the absence of a generic capital allowance will become problematic. The government must provide reassurance to those sectors of the business community that at present operate under tax uncertainty because of this unsettled issue. ■

[12] Review of Business Taxation, "A Tax System Redesigned: More Certain, Equitable and Durable (Final Report)," at 369-409 (1999).